LIBRARY
SUPREME COURT U.S.

Office-Supreme Court, U.S.
FILED
SEP 26 1961
JAMES R. BROWNING, Clerk

No. 363

In the Supreme Court of the United States

OCTOBER TERM, 1961

O. LIQUIDATING CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

ARCHIBALD COX,
Solicitor General,
LOUIS F. OBERDORFER,
Assistant Attorney General,
MELVA M. GRANEY,
DOUGLAS A. KAHN,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument	5
Conclusion	11
Appendix	12

CITATIONS

Cases:

Advertisers Exchange, Inc. v. *Commissioner*, 240 F. 2d 958, affirming *per curiam*, 25 T.C. 1086 — 8, 9

Beacon Publishing Co. v. *Commissioner*, 218 F. 2d 697 — 5, 9, 10

Brown v. *Helvering*, 291 U.S. 193 — 8

Commissioner v. *Hansen*, 360 U.S. 446 — 8

Corn Products Co. v. *Commissioner*, 350 U.S. 46 — 7

Kahuku Plantation Co. v. *Commissioner*, 132 F. 2d 671 — 8

Statutes:

Internal Revenue Code of 1939:

Sec. 41 (26 U.S.C. 1952 ed., Sec. 41) — 2, 6, 7, 12

Sec. 42 (26 U.S.C. 1952 ed., Sec. 42) — 2, 12

Internal Revenue Code of 1954:

Sec. 446(e) (26 U.S.C. 446(e)) — 7

Miscellaneous:

Rev. Rul. 59–285, 1959–2 Cum. Bull. 458, 459–460 — 7, 8, 9

Treasury Regulations 118 (1939 Code):

Sec. 39.41–2 — 2, 6, 13

Sec. 39.41–3 — 2, 14

Treasury Regulations, Income tax (1954 Code):

Sec. 1.446–1(e) — 7

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 363

O. LIQUIDATING CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 6a–20a)[1] are not officially reported. The majority and dissenting opinions of the Court of Appeals (Pet. A1–A13) are not yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered on June 14, 1961. The petition for writ of certiorari was filed on August 28, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R." refers to the appendix to the Government's brief in the court below.

QUESTION PRESENTED

Whether the Commissioner abused his statutory discretion in refusing to consent to a change in taxpayer's method of accounting for a material item of gross income (insurance dividends) where the required consent to the change was not requested by taxpayer in accordance with the applicable Treasury Regulations and where, in the absence of an agreement as to the terms and conditions under which the change was to be effected (also required by the Regulations), the change would doubtless result in relieving from income and excess profits taxation a portion of the income properly attributable to 1952 [redacted] 1953.

STATUTES AND REGULATIONS INVOLVED

Sections 41 and 42(a) of the Internal Revenue Code of 1939, and Sections 39.41–2 (b) and (c) and 39.41–3 of Treasury Regulations 118 are set forth in the Appendix, *infra*, pp. 12–14.

STATEMENT

The taxpayer has at all times kept its books and reported its income on a calendar year and accrual basis. (Pet. A2.)

In the year 1918 taxpayer established and has since broadened and continuously maintained a group insurance plan for its employees. The premiums on the policies obtained pursuant to that plan were paid by taxpayer in monthly installments. In January of each year the actuarial department of the insurance company with whom taxpayer's policies were written would compute the surplus earned in the prior year and recommend a dividend formula to the board of

directors. At its regular meeting in February, the board would consider the actuarial report and determine the amount of dividend to be distributed. (Pet. A2–A3.)

The policies here involved were purchased on varying dates beginning with 1941. During the years 1941 through 1952, inclusive, taxpayer, at the end of each year, accrued the dividend that it estimated it would receive from the insurance company in the following year. Taxpayer then subtracted the estimated dividends from the sum of the premiums it had paid during the year and reported the difference as a deduction in its federal income tax return. (Pet. A3.)

In the years 1941 through 1949 taxpayer's estimates of the dividends it would receive in the following year were correct to the penny. In the year 1950 taxpayer underestimated and in 1951 overestimated this item, but in 1952 it again estimated the exact amount. (Pet. A3–A4.)

Without requesting the approval of the Commissioner, taxpayer changed its method of reporting this item in 1953. In that year, taxpayer accrued no dividends and deducted the full amount of its group insurance premiums from its federal income and excess profits tax return.[2] In 1954, taxpayer received dividends totalling $114,117.44, which amount it accrued and reported in its return for that year. (Pet. A4.)

---

[2] Taxpayer received a dividend of $72,531.79 in 1953. However, that item had been accrued and reported by it in 1952, pursuant to its consistent accounting practice. Had taxpayer adhered to its method of accounting, it would have accrued and reported in 1953 the dividend receivable in 1954. (Pet. A4.)

In 1956 the Commissioner examined taxpayer's federal income and excess profit tax return for the year 1953 and made an adjustment decreasing taxpayer's claimed deduction for insurance premiums by $114,117.44; *i.e.*, he determined that the dividend received by taxpayer in 1954 should have been accrued and reported in 1953. As a result of this adjustment, taxpayer's net deduction for insurance expenses was reduced from $265,327 to $151,209.56. (Pet. A4–A5.)

The Tax Court held that the insurance dividends were properly accruable in the year of distribution, and that the taxpayer's practice of accruing them in the prior year was erroneous. The Tax Court further held that the change in the treatment of this item by taxpayer in its 1953 federal tax return did not constitute a change in its method of accounting which would require the prior approval of the Commissioner. Accordingly, the Tax Court held that the dividend received by taxpayer in 1954, having accrued in that year rather than in 1953, was properly reported in the later year. However, the court accepted the Commissioner's alternative argument that, in view of the above holdings, the taxpayer erred in failing to report in 1953 the dividend it received in 1953 but which it had accrued and reported in 1952. The court adjusted the 1953 return accordingly and determined a deficiency of $50,772.28 for that taxable year.[3] In a dictum, however, the Tax Court stated (R. 20a) that since the dividend received in 1953 had already been accounted for in 1952, "it appears that

[3] The deficiency determined by the Commissioner, using the dividend for 1954 rather than 1953, was $78,851.43. (Pet. A5.)

petitioner [taxpayer] will have adequate relief from double inclusion of an item of gross income by virtue of these sections [1311–1314] of the 1954 Code."[4] The net result of the Tax Court's holding, and of its dictum (if applied), is that one year's dividend would be deleted and the net insurance expense deduction for that year increased to that extent. (Pet. A5.) It is this decision which taxpayer seeks to reinstate.

The Court of Appeals held that the change in 1953 of taxpayer's method of treating this item constituted a change in its method of accounting which under the applicable statutes and Regulations might be made only with the Commissioner's consent. Further, the court held that, since the attempted change would, if effective, likely result in relieving taxpayer entirely of its income and excess profit tax liability for this item for the year 1952, the Commissioner did not abuse his discretion in refusing to grant retroactive consent to taxpayer's unilateral change in its method of accounting for the insurance dividend income. Accordingly, the court below, with one judge dissenting, reversed the Tax Court. (Pet. A1–A13.)

ARGUMENT

The decision below is correct. *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 697 (C.A. 10th), alleged to be in conflict, is consistent with the present case in rationale and is distinguishable on its facts. There is no other occasion for further review.

---

[4] R. 20a.

1. Section 41 of the Internal Revenue Code of 1939 (*infra,* p. 12) provides that the net income of a taxpayer shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting he regularly employs in keeping his books (unless he has not employed such a method or the Commissioner determines that the method he employs does not clearly reflect his income). The instant taxpayer employed the calendar year, accrual method of accounting, except that each year it consistently deducted from the premiums it paid during the year on the insurance policies for its employees the amount of insurance dividends it estimated it would receive from the insurance company in the following year by virtue of the payment of such premiums. This method of treating the insurance dividends, which was not a true accrual method, was subject to question by the Commissioner, who did not, however, question it. It could also be changed at taxpayer's initiative, and the changed method could be employed for income tax purposes, but only under certain conditions. Section 39.41–2 of Treasury Regulations 118, promulgated under the 1939 Code (*infra,* pp. 13–14), provides that a taxpayer who changes his method of accounting shall secure the consent of the Commissioner before computing his income under the new method, that a change in the method of accounting includes any change in the accounting treatment of items of income or deductions, that application must be made to the Commissioner for permission to make the change, and that such permission "will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions

under which the change will be effected."[5] More recently, Revenue Ruling 59–285 (1959–2 Cum. Bull. 458, 459–460), which further reflects the administrative interpretation of Code Section 41 and is therefore to be followed unless clearly inconsistent with the statute (*Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 52–53), also explains that the prior consent of the Commissioner must be obtained before a taxpayer may change his method of accounting "with respect to a material item" and "whether or not the taxpayer regards the method from which he desires to change to be proper."

Despite these clear instructions, the instant taxpayer claims that the Commissioner's consent was not necessary to the change it made in 1953, when it began taking the insurance dividends into income in the year they were actually received rather than in the prior year. In support of its position it urges that the change it made was not in its method of accounting, because it did not change from the overall accrual method it had been using and because its treatment of the insurance dividends was erroneous under the accrual method. Its other arguments (Pet. 12–23) seem also to be based on those premises. But it is a fact that taxpayer changed its accounting treatment as to the insurance dividends, a material item,[6] and that this, under Treasury practice (particularly as specifi-

[5] These requirements have been incorporated in the 1954 Internal Revenue Code and regulations. See 26 U.S.C. 446(e) and Treasury Regulations § 1.446–1(e).

[6] The dividends in question amount to more than $114,000, substantially more than the dividends received in prior years.

cally reflected in Rev. Rul. 59–285, *supra*), constituted a change in its method of accounting requiring the prior consent of the Commissioner.

The ultimate question, therefore, is whether the Commissioner abused his discretion in not accepting the change which taxpayer made in 1953 in its method of accounting as to the insurance dividends. In this connection it is important to note the purpose of the Treasury Regulations requiring not only the consent of the Commissioner to a change in accounting method but an accompanying agreement between the taxpayer and the Commissioner as to the terms and conditions under which the change will be effected. Recognizing that a distortion of income may result from a change in accounting method as to any material income or deduction item, the Regulations impose upon the Commissioner the responsibility of insuring that the distortion will not be to the detriment of the Government. See *Kahuku Plantation Co.* v. *Commissioner,* 132 F. 2d 671 (C.A. 9th); *Advertisers Exchange, Inc.* v. *Commissioner,* 240 F. 2d 958 (C.A. 2d), affirming *per curiam,* 25 T.C. 1086. The Commissioner, whose discretion in the matter is broad (*Brown* v. *Helvering,* 291 U.S. 193, 203–205; *Commissioner* v. *Hansen,* 360 U.S. 446, 467), can hardly be held to have abused that discretion when his consent to a change in accounting method, and his agreement to terms and conditions under which the change was to be effected, were not even sought and the change, in the absence of such an agreement, would result in a tax windfall to taxpayer. See n. 7, *infra.* The decision below is in accord not only with the con-

sistent administrative interpretation and practice (Rev. Rul. 59–285, *supra*) but with the only other Court of Appeals decision directly in point (*Advertisers Exchange, Inc.* v. *Commissioner, supra*).

2. The rationale of the Tenth Circuit in *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 687, is consistent with that of the decision below and, indeed, the two cases are factually distinguishable. In *Beacon* the Commissioner did not wish to condition his approval of a change in accounting methods on an adjustment to prevent the avoidance of taxes. The government explained in its brief to the Tenth Circuit that administrative consent "was here withheld because [Beacon] had not consistently followed a deferral method of reporting over a period of years." Brief for the Respondent at p. 17. Indeed while there would have been a deferral of income tax liability in *Beacon,* no overall avoidance of taxes could result from the change in Beacon's accounting methods, as it would in the present case.[7] The Tenth Circuit

---

[7] The primary source of Beacon's prepaid subscriptions was a campaign organized and carried out during 1942 and the succeeding years. Since the excess profits tax was in effect in 1942, Beacon's erroneous treatment of prepaid subscriptions as income items in 1942 did not avoid any excess profits tax on amounts received in 1942. Since the court held that amounts received for prepaid subscriptions in 1943 and subsequent years were properly treated on a deferral basis, there was also no avoidance of excess profits liability on these items.

In contrast, in the present case, absent a requirement of the Commissioner's consent to petitioner's change in accounting methods and the resulting agreement on adjustments, petitioner's change in accounting method will result in its permanently avoiding a properly attributable excess profits tax. Had petitioner consistently followed the method of accounting which

regarded it as an abuse of the Commissioner's discretion to deny the taxpayer the use of a proper accounting system simply because this system had not been consistently followed in the past. But that court at the same time made clear that the Commissioner was authorized to condition a change in accounting methods upon an adjustment to prevent the avoidance of taxes. It said (218 F. 2d at 702):

> We have no doubt that the taxpayer could not change its method of keeping books without the consent of the Commissioner, even as to items, if the change resulted in an avoidance of the payment of taxes due, nor do we have any doubt but that a taxpayer may, without the consent of the Commissioner, apply the method of accounting which he has adopted, though not theretofore applied to a particular item, when that change will correct errors and clearly reflect his income. We think the change in this case falls within the latter category.

---

both the government and petitioner now accept as correct, petitioner would have had an insurance dividend to set off against its premium expense in every excess profits tax year. If petitioner consistently followed the method of accounting which petitioner had erroneously used in the past, petitioner would likewise have had an insurance dividend to set off against its premium expense in every excess profits tax year. By changing methods of accounting in an excess profits tax year petitioner has attempted to eliminate the effect of the insurance dividend in one year of the excess profits tax. The Tax Court decision does not prevent this result but merely shifts the year of avoidance from 1953 to 1952. Under the decision of the Third Circuit below such a resulting avoidance of a proper tax obligation is prevented, since the Commissioner can refuse to consent to the change unless the taxpayer agrees to make appropriate adjustments.

CONCLUSION

Since the decision of the Third Circuit is manifestly correct and necessary to prevent the use of a change in accounting methods to avoid a proper tax liability and since there is no real conflict among the circuits, it is respectively submitted that the petition for a writ of certiorari should be denied.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
MELVA M. GRANEY,
DOUGLAS A. KAHN,
Attorneys.

SEPTEMBER 1961.

APPENDIX

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (26 U.S.C 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 118 (1939 Code):

SEC. 39.41-2 *Bases of computation and changes in accounting methods.* * * *

(b) The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)-1 to 39.22(c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42-4); or a change involving the adoption of, or a change

in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22(a)-7 and 39.23(a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)-1 to 39.22(d)-7, inclusive, with respect to changing the last-in first-out method of inventorying goods.

* * * * *

Sec. 39.41-3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * *

* * * * *